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IN THE

Supreme Court of the United States

A. ELLIOT ARCHER and CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF OF *AMICUS CURIAE* G. ERIC BRUNSTAD, JR. IN SUPPORT OF PETITIONERS

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INTEREST OF THE AMICUS

Amicus curiae G. Eric Brunstad, Jr. respectfully submits this brief in support of the petitioners. Pursuant to Rule 37.3(a), all parties have consented to the filing of this brief.[1]

The undersigned *amicus* is a Visiting Lecturer of Law at the Yale Law School where he teaches courses on bankruptcy law, business reorganizations, and secured transactions. He has taught at Yale since 1992, and has also taught at the Harvard Law School.

In addition to teaching, the undersigned is the current Vice-Chair of the ABA Business Bankruptcy Committee. He is also a partner with the law firm of Bingham McCutchen LLP, practicing in the area of bankruptcy law and bankruptcy appeals. He is a contributing author to the Collier treatise on bankruptcy and is responsible for multiple chapters of the treatise. He has argued before the Court, and has participated in several bankruptcy cases in the Court.

The undersigned is interested in the administration of bankruptcy law, particularly matters relating to the administration of the discharge in bankruptcy. He has studied and published articles on a variety of bankruptcy topics, including the history of bankruptcy law and the evolution of the discharge. The basic perspective of the undersigned is that, although it is vital to recognize the critical importance of the discharge to insolvent debtors, it is also vital to ensure

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1. Pursuant to Supreme Court Rule 37.6, *amicus curiae* states that no counsel for any party to this dispute authored this brief in whole or in part and no person or entity, other than *amicus curiae*, made a monetary contribution to the preparation or submission of this brief. To the extent not previously filed, copies of the relevant letters of the parties consenting to the filing of this brief are lodged herewith.

the integrity of the bankruptcy system by preventing the discharge of obligations arising in connection with fraudulent activities. Consistent with Supreme Court Rule 37.1, the purpose of this brief is to bring to the Court's attention matters that other parties do not intend to address, particularly relating to historical matters bearing on the discharge issues arising in this case, the role of the bankruptcy courts as courts of equity, and the overall operation of the bankruptcy laws as is relevant to this case.

STATEMENT

In May of 1992, petitioners Elliot and Carol Archer (the "Archers") purchased a manufacturing company from respondent Arlene Warner and her husband, Leonard Warner (collectively, the "Warners"). (JA 41, ¶ 28). Thereafter, the Archers filed suit against the Warners in state court alleging fraud in the transaction. (JA 34). On the eve of trial, the parties entered into a settlement agreement resolving the litigation and, ultimately, a pending criminal indictment against Leonard Warner. (JA 61-63).

The terms of the settlement provided that the Warners would pay the Archers $300,000. (JA 61). This consisted of a $200,000 cash payment combined with a promissory note for $100,000 payable in two installments. (JA 61-62, ¶¶ 1, 2). In exchange, the Archers agreed to release the Warners from all claims related to the state court litigation. (JA 63). The release specifically excluded the Archers' debt to the Warners under the promissory note. (JA 67).

Shortly after the parties entered into the settlement, the Warners defaulted on the note. (JA 87, ¶ 6). When the Archers brought suit in state court to enforce the note, the Warners filed for relief under chapter 13 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq*. (JA 86, 87, ¶¶ 2, 11). The immediate

effect of the filing was to prevent the Archers from continuing their state court collection action. *See* 11 U.S.C. § 362(a). Thereafter, the Bankruptcy Court converted the Warners' case to a liquidation proceeding under chapter 7. *See* 11 U.S.C. § 1307. (JA 87, ¶ 3).

During the chapter 7 case, the Archers commenced an adversary proceeding in the Bankruptcy Court seeking a determination that the Warners' debt to them was nondischargeable on the ground, *inter alia*, that the obligation was for money or property obtained by fraud. *See* 11 U.S.C. § 523(a)(4); *see also* Fed. R. Bankr. P. 4007. (JA 89, ¶ 18). Leonard Warner did not contest the issue of nondischargeability, and the court entered a consent judgment against him. (JA 12, ¶ 16). In contrast, Arlene Warner did contest the nondischargeability of the debt. She alleged that the underlying liability did not involve any fraud by her, and that the settlement barred the Archers from asserting fraud as a basis for denying her discharge. (JA 93).

The Bankruptcy Court agreed with Arlene Warner's second argument, concluding on the basis of the settlement that the Archers "effectively released and extinguished the dischargeability claim which they now seek to assert against the defendant." (Pet. App. 35a). The District Court affirmed, also concluding that the settlement agreement barred inquiry into the fraudulent basis of the underlying debt. (Pet. App. 20a-25a). On further appeal, a panel of the Court of Appeals likewise affirmed, with one judge dissenting. *In re Warner*, 283 F.3d 230 (4th Cir. 2002).

In affirming the judgment, the Court of Appeals reasoned that the settlement agreement extinguished the Archers' fraud claim by substituting in its place a contractual obligation for the payment of money. *Id.* at 237. In the court's view, this "novation" properly foreclosed further inquiry into the nature of the underlying obligation for discharge purposes. *Id.* at 236. The court reasoned that its approach would promote settlements. *Id.*

In reaching this conclusion, the court sided with the Seventh and Ninth Circuits, which also have refused to look through the terms of a settlement agreement if the agreement released all underlying fraud claims in exchange for a contractual debt. *See In re Fischer*, 116 F.3d 388 (9th Cir. 1997); *In re West*, 22 F.3d 775 (7th Cir. 1994); *Maryland Casualty Co. v. Cushing*, 171 F.2d 257 (7th Cir. 1948). In contrast, the court acknowledged that its view was contrary to the approach taken by the D.C. and Eleventh Circuits. Under this second approach, a settlement agreement does not preclude a claim of nondischargeability if the creditor can demonstrate that the underlying debt involved fraud on the part of the debtor. *See United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995); *Greenberg v. Schools*, 711 F.2d 152 (11th Cir. 1983).

SUMMARY OF ARGUMENT

The history of the discharge in bankruptcy is one of an expanding concept marked by three interrelated themes: the promotion of relief for the "honest but unfortunate debtor," the corresponding denial of relief for obligations arising from fraud, and the generous exercise of the equitable powers of the bankruptcy courts to ensure the fulfillment of both goals. For over a century, the courts have been empowered to sift the circumstances surrounding the treatment of claims in bankruptcy to ensure that liabilities involving fraud do not find shelter within the bankruptcy system. Because the decision of the Court of Appeals effectively abandons the logic, history, and purpose of this tradition, and is contrary to the structure and operation of the Bankruptcy Code, reversal is warranted.

Under the decision below, a debtor may effectively convert a nondischargeable debt for fraud into a fully dischargeable contractual obligation by the simple expedient

of entering into a settlement agreement that offers a contractual promise of payment in exchange for a release of the prior liability. Thereafter, the debtor may freely default on the obligation with the knowledge that bankruptcy law will release the debtor from his or her burden, even though the underlying obligation would not have been dischargeable absent the settlement. The professed virtue of this procedure is that, by sanctioning the conversion of nondischargeable fraud claims into dischargeable contractual obligations, it encourages debtors accused of fraud to enter into settlements in which they promise restitution to their victims in exchange for a release. But by the same token, it also encourages the perpetrators of fraud to settle their claims for illusory sums, and then file for bankruptcy to extinguish them. In the final analysis, for debtors that fail to honor the terms of their settlements, the rule embraced by the court below effectively compromises the integrity of the bankruptcy system by offering shelter for defaulting perpetrators of fraud.

Nothing in the Bankruptcy Code compels or even suggests this result. On the contrary, the very purpose of the rule prohibiting the discharge of liabilities associated with fraudulent conduct is to limit the scope of bankruptcy relief to obligations that are free from the taint of fraud. As a matter of contract, a settlement agreement may release a debtor from the burden of the creditor's suit. That should not mean, however, that the same settlement agreement can prevent a bankruptcy court from examining the underlying nature of a settled obligation to ensure in the administration of the Nation's bankruptcy laws that the debtor's discharge applies only as Congress intended.

For over a century, this Court has instructed that, in the administration of bankruptcy proceedings, substance must not give way to form, and the courts must apply the salient

provisions of the bankruptcy laws to effectuate their underlying policies. This Court has especially adhered to that teaching in the application of the debtor's discharge in bankruptcy, concluding specifically that a state court consent judgment entered on a settled fraud claim would not preclude the bankruptcy court from examining the underlying nature of the claim for discharge purposes. *See Brown v. Felsen*, 442 U.S. 127 (1979). In order to limit discharge relief as Congress intended, the Court should reach the same conclusion in this instance and reverse the judgment below.

ARGUMENT

A. Although the History of the Discharge in Bankruptcy Is One of an Expanding Concept, Relief Has Been Limited to the "Honest But Unfortunate Debtor."

For much of English history, a debtor who could not pay his or her debts was treated as a criminal offender. Prior to the nineteenth century, imprisonment for debt was common, and in the words of one seventeenth-century English jurist:

> If a man be taken in execution, and lie in prison for debt, neither the plaintiff, at whose suit he is arrested, nor the sheriff who took him, is bound to find him meat, drink, or clothes; but he must live on his own, or on the charity of others; and if no man will relieve him, let him die in the name of God, says the law; and so say I.[2]

2. Peter J. Coleman, Debtors and Creditors in America 5 (1974) (quoting Sir Robert H. Hyde, J.). *See* G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 Bus. Law. 499, 519-21 & n.89 (2000) [hereinafter "*Brunstad, Bankruptcy*"] (discussing the practice of imprisonment for debt under English law).

Not surprisingly, the earliest English bankruptcy laws were little more than debt-collection devices intended to repress insolvent obligors.[3] A revised version of the first English bankruptcy statute went so far as to prescribe the death penalty for fraudulent debtors.[4] Under certain circumstances, mutilation of the debtor was also authorized.[5] By 1705, however, English law began to experiment with the concept of a discharge in bankruptcy to relieve honest but unfortunate bankrupts from the burdens of impossible indebtedness.[6]

In the United States, imprisonment for debt was also common well into the nineteenth century.[7] During periods of

3. *See* 1542, 1 Hen. 8, ch. 4, § 1 (Eng.); 1571, 13 Eliz., ch. 7, § 1 (Eng.); 1604, 1 Jam. 1, ch. 15, § 9 (Eng.); *Brunstad, Bankruptcy, supra* note 2, at 515-16.

4. *See* Gerrard Glenn, *Essentials of Bankruptcy: Prevention of Fraud, and Control of Debtor*, 23 Va. L. Rev. 373, 381 (1937) (under English law, "the failure of a bankrupt to surrender to the court, perjury upon his examination, and the fraudulent concealment of assets, were all made hanging offenses").

5. *See* Louis Edward Levinthal, *The Early History of English Bankruptcy*, 67 U. Pa. L. Rev. 1, 17 (1919) (observing that pillory and the loss of an ear were the "penalt[ies] imposed upon [the] debtor who failed to show that bankruptcy was due solely to misfortune").

6. *See* 1705, 4 Anne, ch. 17, § 7 (Eng.); *see also Brunstad, Bankruptcy, supra* note 2, at 515-56 & n.60 (discussing this statute). The origins of the discharge in bankruptcy are truly ancient. The Bible states: "At the end of every seven years you shall grant a release. And this is the manner of the release: every creditor shall release what he has lent to his neighbor; he shall not exact it of his neighbor, his brother, because the Lord's release has been proclaimed." *Deut.* 15:1-2. *See also Brunstad, Bankruptcy, supra* note 2, at 523-25 (discussing the history of debt forgiveness in bankruptcy law).

7. *See Brunstad, Bankruptcy, supra* note 2, at 519, 521 & n.91 (discussing the practice of imprisonment for debt in the United States, and its eventual abolishment).

financial turmoil, insolvent obligors would often fill the jails, prompting agitation for relief.[8] In response to the profound economic crisis generated by the war with France in 1799, and a succession of failed land speculations, Congress was moved in 1800 to enact the Nation's first bankruptcy law.[9] Although unpopular and short-lived, the Act provided a discharge for many insolvent merchants, including Robert Morris, the great financier of the Revolution, who at the time had spent three years in the Prune Street Jail in Philadelphia for debts of about $12 million from failed land speculations.[10]

Under the Act of 1800, discharge relief was proscribed if a creditor could show "any ficticious or false debt" or that the debtor had lost significant sums through gambling.[11] Beset with

8. *See id.*, at 519; Charles Warren, Bankruptcy in United States History 18-19, 55-57, 69-72, 95-105 (1935) [hereinafter "*Warren, History*"].

9. Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (1800) (repealed 1803); *see Warren, History, supra* note 8, at 18-19 (discussing events leading to the enactment of the Act of 1800); F. Regis Noel, A History of the Bankruptcy Clause of the Constitution of the United States of America 124-33 (1918) [hereinafter "*Noel, History*"] (same).

10. *See Brunstad, Bankruptcy, supra* note 2, at 517; Bankruptcy Act of 1800, ch. 19, § 34, 2 Stat. 30 (1800) (repealed 1803) (providing that "every such bankrupt shall be discharged from all debts by him or her due or owing, at the time he or she became bankrupt"); Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. 325, 346-47 (1991) [hereinafter "*Tabb, Discharge*"] (discussing the discharge under the Act of 1800); 1A Collier on Bankruptcy, ¶ 14.01 at 1246.1 (14th ed. 1979) (explaining that a discharge under the Act of 1800 required the consent of two-thirds of the debtor's creditors).

11. Bankruptcy Act of 1800, ch. 19, § 37, 2 Stat. 31-32 (1800) (repealed 1803).

criticisms that the act was too lenient on debtors and facilitated fraud, Congress repealed the measure shortly after its passage.[12]

Following the extended economic crisis occasioned by the depression of 1837, Congress subsequently enacted the Nation's second bankruptcy law in 1841.[13] Like the Act of 1800, the new law allowed a discharge.[14] At the same time, it also expanded the grounds for denying discharge relief, including "if [the] bankrupt shall be guilty of any fraud or willful concealment of his property."[15] Like the Act of 1800, this measure proved controversial, and Congress repealed it in 1843.[16]

Following the Panic of 1857 and the widespread dislocation caused by the Civil War, Congress enacted the Nation's third bankruptcy law in 1867.[17] This act further liberalized the

12. *See Noel, History, supra* note 9, at 124-33 (discussing enactment and repeal of the Act of 1800); 3 Joseph Story, Commentaries on the Constitution 8 (1833) (criticizing the repeal of the Act).

13. Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (1841) (repealed 1843); *see Warren, History, supra* note 8, at 55-57, 69-72 (discussing events leading to the enactment of the Act of 1841).

14. *See* Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 443-44 (1841) (repealed 1843); *Tabb, Discharge, supra* note 10, at 351-52 (discussing the discharge under the Act of 1841); 1A Collier on Bankruptcy, ¶ 14.01 at 1247 (14th ed. 1979) (explaining that a discharge under the Act of 1841 could be blocked by a majority of creditors filing written dissents asserting just cause).

15. Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 443-44 (1841) (repealed 1843).

16. *See Noel, History, supra* note 9, at 134-44 (discussing events surrounding the enactment and repeal of the Act of 1841).

17. Bankruptcy Act of 1867, ch. 176, 14 Stat. 517 (1867) (repealed 1878); *see Warren, History, supra* note 8, at 95-105 (discussing events leading to the enactment of the Act of 1867).

availability of a discharge.[18] At the same time, it also expanded the grounds for its denial, including if the debtor was guilty of "any fraud or negligence in the care [of his property]," "any false or fraudulent entry in any book of account or other document, with intent to defraud his creditors," or "any fraud whatever contrary to the true intent of this act."[19] The act also specifically excepted from discharge all debts "created by the fraud or embezzlement of the bankrupt or by his defalcation as a public officer, or while acting in any fiduciary capacity."[20] Somewhat longer-lived than its predecessors, the law endured until Congress repealed it in 1878.[21]

Congress's next bankruptcy law, the Bankruptcy Act of 1898, further liberalized the availability of the discharge while again excepting a variety of frauds from the scope of the Act's discharge provisions.[22] As initially enacted, section

18. *See* Bankruptcy Act of 1867, ch. 176, § 34, 14 Stat. 533 (1867) (repealed 1878); *Tabb*, *Discharge*, *supra* note 10, at 359-60 (discussing the discharge under the Act of 1867); 1A Collier on Bankruptcy, ¶ 14.01 at 1247 (14th ed. 1979) (explaining that a discharge under the Act of 1867 required the debtor's assets to equal fifty percent of claims, unless the debtor obtained the consent of a majority of creditors, and observing that this requirement was modified to make discharge easier to obtain by amendment to the Act in 1874).

19. Bankruptcy Act of 1867, ch. 176, § 29, 14 Stat. 531-32 (1867) (repealed 1878).

20. *Id.*

21. *See Noel*, *History*, *supra* note 9, at 145-56 (discussing events surrounding the enactment and repeal of the Act of 1867).

22. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), amended by the Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed

(Cont'd)

17 of the Act excepted from discharge "judgments in actions for frauds, or obtaining property by false pretenses or false representations." 11 U.S.C. § 35 (repealed 1979).[23] *See Bullis v. O'Beirne*, 195 U.S. 606, 615 (1904) (construing this provision). Dissatisfied with this provision, Congress amended it in 1903, replacing the term "judgments" with the broader concept of "liabilities."[24] The legislative history to this amendment indicates that the change was made "in the interest of justice and honest dealing and honest conduct" and was intended "to exclude beyond peradventure certain liabilities *growing out of* offenses against good

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1979). *See Noel*, *History*, *supra* note 9, at 157-80 (discussing the enactment of the Act of 1898). The discharge provisions of the Act of 1898 were considerably more generous than those of the Acts of 1800, 1841, or 1867. *See* Bankruptcy Act of 1898, § 14, 30 Stat. 550 (repealed 1979); *Tabb*, *Discharge*, *supra* note 10, at 366-68 (discussing the discharge under the Act of 1898); 1A Collier on Bankruptcy, ¶ 14.01 at 1247-1260.1 (14th ed. 1979) (discussing the discharge under the Act of 1898 and the various amendments to the Act). The Act of 1898 is the predecessor to the current Bankruptcy Code, 11 U.S.C. § 101 *et seq*. In drafting the Act of 1898, Congress distinguished between circumstances that would result in the complete denial of a discharge to the debtor, and debts that were not subject to the debtor's discharge. The former were set forth in section 14c of the Act, and the latter in section 17. *See* 11 U.S.C. §§ 32, 35. The current Bankruptcy Code likewise maintains this distinction. For example, section 727 describes the circumstances in which a court may deny a debtor a discharge in a chapter 7 case. *See* 11 U.S.C. § 727. In contrast, section 523 prescribes categories of debts excepted from the scope of the debtor's discharge. *See* 11 U.S.C. § 523.

23. Bankruptcy Act of 1898, ch. 541, § 17a, 30 Stat. 550-51 (1898) (repealed 1979).

24. Ch. 487, § 5, 32 Stat. 798 (1903) (repealed 1979).

morals." H.R. Rep. No. 1698, 57th Cong., 1st Sess., 3, 6 (1902) (emphasis added).[25]

Explaining the essential purpose of the discharge provisions, this Court repeatedly stressed the law's animating policy of affording bankruptcy relief to the "honest but unfortunate debtor." As summarized in *Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934):

> One of the primary purposes of the Bankruptcy Act is to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes. . . . This purpose of the act has been again and again emphasized . . . in that it gives the honest but unfortunate debtor . . . a new opportunity in life. . . . The various provisions of the Bankruptcy Act were adopted in light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act.

Conversely, the Court stressed the inappropriateness of affording discharge relief to certain wrongdoers, including the perpetrators of fraud. For example, in *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904), the Court refused to apply the discharge to excuse a debtor's obligation to support his family:

> The bankruptcy law should receive such an interpretation as will effectuate its beneficent

25. Congress subsequently amended section 17 numerous times, further expanding its scope. *See* 1A Collier on Bankruptcy, ¶ 17.01 at 1575-80.2 (14th ed. 1979). Of particular relevance, the amendments in 1938 and 1960 further broadened the fraud exception, rendering additional liabilities nondischargeable. *See id.* at 1577-78.

> purposes. . . . Systems of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive. . . . Unless positively required by direct enactment the courts should not presume a design on the part of Congress, in relieving the unfortunate debtor, to make the law a means of avoiding enforcement of the obligation, moral and legal, devolved upon the husband to support [his family].

See also McIntyre v. Kavanaugh, 242 U.S. 138, 142 (1916) ("It was an honest debtor, and not a malicious wrongdoer, that was to be discharged.") (citation omitted); *see generally Edwards v. Kearzey*, 96 U.S. 595, 602 (1877) (observing that imprisonment for debt "is right for fraud, but wrong for misfortune. . . Where there is no fraud, it is the opposite of a remedy.").

With the increase of debtors seeking bankruptcy relief following the passage of the Acts of 1867 and 1898, courts increasingly faced the task of deciding whether particular debts associated in some fashion with fraudulent conduct should fall outside the scope of the discharge provisions. Of particular significance are two lines of cases that illustrate the extent to which courts looked through the form of a particular debt to determine if the obligation in question arose out of fraud, thereby rendering the obligation nondischargeable.

1. Under the Acts of 1867 and 1898, Courts Routinely Looked Through Contractual Obligations to Determine the Presence of Fraud for Purposes of Determining Dischargeability.

Prior to the 1970 amendments to the Bankruptcy Act of 1898, questions concerning the nondischargeability of a particular debt were largely decided outside the bankruptcy forum.[26] Typically, a debtor who obtained a discharge would plead the discharge as a defense when sued by a creditor to enforce a discharged obligation. In turn, the creditor could overcome the debtor's defense by demonstrating that the obligation fell within one of the categories of nondischargeable debts enumerated in the bankruptcy statutes.

Significantly, many of these suits involved collection actions brought to enforce contractual obligations arising from promissory notes. Not surprisingly, debtors would frequently attempt to limit the court's inquiry into the underlying nature of the transaction giving rise to a particular note in order to avoid the revelation of any connection with fraudulent conduct, while creditors would often seek to expand this inquiry. For discharge purposes, courts developed the practice of looking beneath the form of a promissory note to determine if the circumstances surrounding the underlying transaction revealed evidence of fraud.

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26. Although only federal courts exercising bankruptcy jurisdiction could grant a discharge, prior to 1970, the determination of whether a particular debt fell outside the scope of the debtor's discharge was largely left for nonbankrutpcy courts to decide. In 1970, Congress amended section 17 to provide that the bankruptcy courts had the power to resolve the issue of nondischargeability. *See Brown v. Felsen*, 442 U.S. 127, 129-30 (1979) (explaining change); 1A Collier on Bankruptcy, ¶ 17.01 at 1580-80.2, 1745-50 (14th ed. 1979) (same).

In the seminal case of *Argall v. Jacobs*, 87 N.Y. 110 (1881), a creditor brought suit against a debtor to enforce a series of promissory notes that the debtor procured by fraud. The debtor sought to defend the action by interposing his discharge under the Act of 1867. In response, the creditor argued that the debtor's discharge did not apply owing to the existence of fraud in the underlying transaction. The debtor countered that the form of the creditor's action did not properly involve any allegation of fraud, but had been brought merely to enforce the notes, thereby preventing any inquiry into the debtor's alleged fraud for discharge purposes. The court disagreed, reasoning that, because the debtor had been guilty of fraud in issuing the notes, the debt was nondischargeable regardless of the character of the creditor's lawsuit:

> These promissory notes were debts of the defendants, and the plaintiff was induced by the fraud of the defendants to sell goods to them and take their notes therefore, and hence these debts were created by their fraud within the meaning of the Bankruptcy Act. It was not needful that the plaintiff should allege the fraud in his complaint.

Id. at 113-14.

Similarly, in *Strang v. Bradner*, 114 U.S. 555 (1885), two debtors procured notes by fraud, and the injured creditors brought suit to recover their losses. In analyzing the dischargeability issue, the Court reasoned that it made no difference whether the creditors asserted claims for fraud or for contractual indemnity on the notes. Emphasizing that "no *debt created by the fraud* of the bankrupt shall be discharged," *id.* at 560-61, the Court explained that "[i]t is . . . clear that, whether the claim asserted by plaintiffs is regarded as one arising out of deceit or fraud by the defendants, or as a debt

created by their fraud, the discharges in bankruptcy do not constitute a defense." *Id.* at 561.

Decisions under the subsequent Act of 1898 involving promissory notes likewise followed this approach. For example, in *Gregory v. Williams*, 189 P. 932 (Kan. 1920), a man procured $200 from a woman based on fraudulent representations. When she discovered the fraud, she demanded return of the funds. Unable to pay, he gave her a promissory note. When he defaulted on the note, she brought suit to enforce it. After the man filed for bankruptcy, he asserted that the note fell within the scope of his discharge as a contractual liability. The court disagreed, finding the obligation to have arisen as a result of the man's fraud, concluding for bankruptcy purposes that the "fraud was not extinguished when the note was given." *Id.* at 933. The court further reasoned:

> Taking the note by the plaintiff after she had discovered the defendant's fraud . . . did not take the indebtedness that was evidenced by the note out of the operation of section 17 of the Bankruptcy Act. The debt remained one for obtaining property by false pretenses and false representations, and the fraud was not waived, so as to discharge the defendant from his obligation to pay.

Id. at 934.

Likewise, in *Mathewson v. Naylor*, 18 Cal. App. 2d 741, 64 P.2d 979 (Cal. Ct. App. 1937), the debtor issued a promissory note to his creditor to cover certain debts incurred on the basis of false representations. After the debtor defaulted, the creditor sued on the note, and the debtor interposed his discharge as a defense, arguing that the note extinguished the fraud. Rejecting this argument, the court concluded:

> There was, therefore, evidence sufficient to have supported a finding that the defendant had obtained the money of the plaintiff by false representations. Even if the notes given thereafter may be said to have waived the fraud and substituted a contractual obligation in its place, nevertheless, inasmuch as the notes represented a liability which had in its inception in the securing of money by the making of false representations, the action on the note would not be barred by a discharge in bankruptcy.

Id. 18 Cal. App. 2d at 744, 64 P.2d at 981; *see also United States Credit Bureau v. Manning*, 147 Cal. App. 2d 558, 561, 305 P.2d 970, 972 (Cal. App. Ct. 1957) ("In an action on a promissory note to which the defendant pleads as a defense his discharge in bankruptcy, it is proper to receive evidence with respect to the nature of the liability represented by the note in order to determine whether it is of a character which is dischargeable."); *American Surety Co. v. McKiernan*, 304 Mich. 322, 325, 8 N.W.2d 82 (Mich. 1943); *Hartford Accident & Indem. Co. v. Flanagan*, 28 F. Supp. 415, 419 (S.D. Ohio 1939); *Symmes v. Rollins*, 93 Ga. App. 53, 146 S.E. 42 (Ga. Ct. App. 1928).

2. Under the Prior Law, Courts Also Looked Through Judgments to Determine the Presence of Fraud for Purposes of Determining Dischargeability.

Courts also developed the practice of looking through judgments to determine if a liability would be excepted from discharge. Numerous cases under the 1898 Act followed this approach, permitting review of evidence extrinsic to a judgment to determine if a liability established by the judgment would be nondischargeable owing to the presence of fraud. Other courts, however, refused to look beneath the

surface of the judgment, often invoking principles of *res judicata* for their refusal. In general, these courts typically concluded that, unless the judgment or record on its face established a liability for fraud, all inquiry regarding any fraudulent underpinnings was foreclosed. *See Brown v. Felsen*, 442 U.S. 127, 130-31, n.4 (1979) (noting split of authority); *see also* 1A Collier on Bankruptcy, ¶ 17.16[4] at 1643-46 (14th ed. 1979) (collecting cases).

In *Brown v. Felsen*, 442 U.S. 127 (1979), this Court resolved this split in favor of the practice of looking through a judgment for evidence of fraudulent conduct. The decision in *Brown* is especially important because the circumstances of that case are virtually indistinguishable from those of the present controversy.

In *Brown*, the creditor ("Brown") guaranteed the obligations of the debtor ("Felsen") to a third-party lender. After the lender brought suit against Brown on the guarantee, Brown asserted a claim against Felsen alleging fraud. The parties settled the suit by stipulation, and the trial court entered a consent judgment based on the settlement. Neither the stipulation nor the judgment specified Brown's theory of recovery, nor did the judgment make any mention of Felsen's fraud.

Thereafter, Felsen filed for bankruptcy and sought to have his debt discharged. Brown, in turn, sought to determine in the bankruptcy court that the obligation fell within the fraud exception of section 17 of the Bankruptcy Act. As the Court noted, pursuant to the 1970 amendments to the Act, the bankruptcy court was authorized to resolve the question of nondischargeability. *Brown*, 442 U.S. at 129-30.

During the course of the litigation, Felsen argued that principles of *res judicata* prevented the bankruptcy court from

looking through the prior state court judgment. The bankruptcy court agreed, concluding that the obligation was dischargeable. On appeal, both the district court and the court of appeals affirmed. On further review, this Court reversed.

Quoting *Local Loan Co. v. Hunt*, the Court observed: "Through discharge, the Bankruptcy Act provides 'a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'" *Id.* at 128 (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)). As the Court also observed, "[b]y seeking discharge, however, respondent [Felsen] placed the rectitude of his prior dealings squarely in issue, for, as the Court has noted, the Act limits that opportunity to the 'honest but unfortunate debtor.'" *Id.*

As the Court further explained, the nondischargeability provisions of section 17 of the Act merely prescribe the "*types* of debts [that] are not affected by a discharge," not the scope of the bankruptcy court's inquiry. *Id.* at 129. The Court concluded:

> Refusing to apply res judicata here would permit the bankruptcy court to make an accurate determination whether respondent in fact committed the deceit, fraud, and malicious conversion which petitioner alleges. These questions are now, for the first time, squarely in issue. *They are the type of question Congress intended that the bankruptcy court would resolve. That court can weigh all the evidence, and it can also take into account whether or not petitioner's failure to press these allegations at an earlier time betrays a weakness in his case on the merits.*

Id. at 138 (emphasis added); *see also Pepper v. Litton*, 308 U.S. 295, 305-06 (1939) (*res judicata* did not preclude the bankruptcy court from reexamining a judgment for purposes of the allowance and payment of a creditor's claim, and, in exercising its function, the court could "look behind the judgment").

Significantly, the Court found additional support for its conclusion in the historical evolution of section 17. Reviewing the expansion of the fraud exception over time, the Court noted that the history indicates that "Congress intended the fullest possible inquiry" into the nature of debts for discharge purposes. *Brown*, 442 U.S. at 138. The Court further explained that this history "suggests that all debts arising out of conduct specified in § 17 should be excepted from discharge and the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." *Id.*

The decision of the Court of Appeals in this case clearly conflicts with the rationale of *Brown* and the broad authority of the bankruptcy courts to inquire into the "true nature" of an obligation for purposes of determining its dischargeability. Because this rationale properly carries over under the discharge provisions of the current Bankruptcy Code, the decision of the court below is likewise at odds with the current law.

B. The Rationale of *Brown v. Felsen* Endures under the Bankruptcy Code, and the Decision of the Court Below Conflicts with the Policy, Structure, and Operation of the Bankruptcy System.

As the Court further observed in *Brown*, the discharge provisions of section 523 are materially the same as those under section 17 of the former Bankruptcy Act. *See Brown v. Felsen*, 442 U.S. at 129 n.1. In relevant part, section 523(a)(2) provides

that a debt is nondischargeable if it is "for money [or] property . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2). Like section 17 of the former Act, although this provision clearly describes a *category* of debt that is nondischargeable, it does not restrict the scope of the bankruptcy court's inquiry in determining whether a particular obligation is excepted from discharge owing to the presence of fraud. *See Cohen v. De La Cruz*, 523 U.S. 213, 220 (1998) (observing that each subsection of section 523(a) introduces "a category of nondischargeable debt"); *Grogan v. Garner*, 498 U.S. 279, 287 (1991) (observing that section 523 renders nondischargeable "certain categories of debts"). Given the similarity between the new law and the old, it is difficult to understand why the bankruptcy court's inquiry under section 523 should be any less extensive or searching than under its predecessor. On the contrary, just as restricting the inquiry of the bankruptcy courts would have violated the policy of the Bankruptcy Act, it likewise makes no sense under the current law.

1. The Relevant Discharge Policy of the Bankruptcy Code Is the Same as the Policy of the Former Law.

As this Court explained in a recent decision construing section 523(a), the general policy animating the discharge exceptions under the Code is the same as under the former section 17: "[t]he Bankruptcy Code has long prohibited debtors from discharging liabilities incurred on account of their fraud, embodying a basic policy animating the Code of affording relief only to an 'honest but unfortunate debtor.'" *Cohen*, 523 U.S. at 217 (quoting *Grogan v. Garner*, 498 U.S. at 287, and citing *Brown v. Felsen*, 442 U.S. at 138). As the Court further explained, the language of section 523, coupled with the Code's broad definitions of "claim" and "debt," compel the conclusion that any debt "arising from" money

or property obtained by fraud falls within the scope of the provision. *Id.* at 218; *see also id.* at 221 (finding that section 523 is best read to prohibit the discharge of "any liability arising from" the debtor's fraud); *Field v. Mans*, 516 U.S. 59, 61, 64 (1995) (describing nondischargeable debts under section 523(a) as including those "traceable to" or "resulting from" fraud); H.R. Rep. No. 95-595 at 309 (1977), *reprinted in* 1978 U.S.C.C.A.N. at 6266 (describing the Code's definition of a "claim" as the "broadest possible" so that "all legal obligations of the debtor . . . will be able to be dealt with in the bankruptcy case"). Obviously, in order to determine whether a particular debt "arises from," is "traceable to," or "results from" fraudulent conduct, the bankruptcy court must often inquire beyond the surface of the particular debt to establish its true origins and character.

As this Court has observed, "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.'" *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (quoting *Emil v. Hanley*, 318 U.S. 515, 521 (1943)). Similarly, "[w]e . . . 'will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.'" *Cohen*, 523 U.S. at 221 (quoting *Pennsylvania Dep't of Welfare v. Davenport*, 495 U.S. 552, 563 (1990)); *see also Davenport*, 495 U.S. at 565 (O'Connor, J., dissenting) ("This Court carefully has set forth a method for statutory analysis of the Bankruptcy Code. [T]he Court presumes that Congress intended to keep continuity between pre-Code judicial practice and the enactment of the Bankruptcy Code in 1978.").

As the Court recognized in *Cohen* and *Field*, the relevant provisions of section 523 descend with only minor alteration from the 1903 provisions of section 17. *See Cohen*, 523 U.S. at 221; *Field*, 516 U.S. at 64-65. Given the continuity of the

text and policy between the relevant statutory enactments, there is no reason to abandon the established practice under the Act of looking through the form of an obligation to determine if it is properly dischargeable. Because the decision of the Court of Appeals abandoned this tradition contrary to the purpose and policy of the discharge provisions of the Code, reversal is warranted.

2. The Decision of the Court Below Conflicts with the Equitable Role and Function of the Bankruptcy Courts.

The decision of the court below also conflicts with the fundamental nature of the bankruptcy courts as courts of equity. As this Court has repeatedly explained, "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934); *see also Young v. United States*, __ U.S. __, 122 S. Ct 1036, 1041 (2002) ("bankruptcy courts . . . are courts of equity and apply the principles of equity jurisprudence"); *United States v. Energy Resources Co.*, 495 U.S. 545, 549 (1990) (stating that "bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); *Bank of Marin v. England*, 385 U.S. 99, 103 (1966) ("There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisprudence."); *Pepper v. Litton*, 308 U.S. 295, 304 (1939) ("a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the [Bankruptcy] Act, it applies the principles and rules of equity jurisprudence"); H.R. Rep. No. 95-595, at 359 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6315 (under the Bankruptcy Code, "[t]he bankruptcy court will remain a court of equity"). Likewise, orders of discharge in bankruptcy are "in every essential particular decrees in

equity." *Local Loan Co. v. Hunt*, 292 U.S. at 241 (citing *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 192 (1902); *Commercial Bank of Manchester v. Buckner*, 20 How. 108, 118 (1857)).

Consistent with their status as equity tribunals, bankruptcy courts have an obligation to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in [the] administration of the bankruptcy estate." *Pepper v. Litton*, 308 U.S. at 308 (footnote omitted). As the Court has observed, this is essential to ensure "that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done." *Id.* at 305.

The power of the bankruptcy court to examine the circumstances surrounding any debt for discharge purposes, including the power to look through settlement agreements to determine if a settled obligation is traceable to fraudulent conduct, is fundamental to its role as a court of equity. "Equity always attempts to get at the substance of things, and to ascertain, uphold, and enforce rights and duties which spring from the *real* relations of parties. It will never suffer the mere appearance and external form to conceal true purposes, objects, and consequences of transactions." *Pomeroy's Equity Jurisprudence*, § 378, p. 41 & n.3 (5th ed. 1941) (quoting *Loomis v. Callahan*, 196 Wis. 518, 220 N.W. 816, 821 (1928) (dissenting opinion; majority opinion overruled by *State of Wisconsin ex rel. Thompson v. Giessel*, 267 Wis. 331, 65 N.W.2d 529, 540 (1954) ("It has always been recognized as the right, if not always as the absolute duty, of a court clothed with equitable jurisdiction which is here properly invoked, to apply its X-rays to masks and covers and see through to the real substance.")); *see generally SEC v. United States Realty & Improv. Co.*, 310 U.S. 434, 457 (1940) ("Good sense and legal tradition alike enjoin that an enactment of Congress

dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part."). In contrast, the approach taken by the court below is inconsistent with these basic concepts. In no sense is it equitable for a bankruptcy court to ignore fraud in the administration of the Bankruptcy Code's discharge provisions. *See Pepper v. Litton*, 308 U.S. at 312 ("when there is . . . a 'planned and fraudulent scheme' . . . the necessity of equitable relief against that fraud becomes insistent."). Because the decision of the Court of Appeals conflicts with the obligation of the bankruptcy court to ensure that fraud does not taint the administration of discharge in bankruptcy cases, it is fundamentally unsound.

3. The Decision of the Court Below Conflicts with the Larger Structure and Operation of the Bankruptcy Code.

Finally, the approach taken by the court below is inconsistent with the structure and operation of the Bankruptcy Code as a whole, and if recognized, would interfere with the Code's successful administration. Embedded in the court's approach is the view that settled obligations should not be disturbed in bankruptcy, not even to fulfill the Code's discharge provisions. But the very nature of bankruptcy law is to alter nonbankruptcy obligations to the extent necessary to serve the goals of the statutory regime. *See Ashton v. Cameron County Water Improv. Dist.*, 298 U.S. 513, 530 (1936) ("The especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned — to change, modify or impair the obligations of their contracts."); *see also United States v. Energy Resources Co.*, 495 U.S. at 549 ("bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); *Northern Pipeline Constr. Co. v. Marathon*

Pipe Line Co., 458 U.S. 50, 71 (1982) (Brennan, J., plurality opinion) ("the restructuring of debtor-creditor relations . . . is at the core of the federal bankruptcy power").

Exercising this authority, courts routinely pierce the form of a variety of transactions in order to administer the Code's remedial provisions. For example, in the administration of the Code's preference rules, courts have often looked through the form of a transaction to discern its substance. *See White v. Cotzhausen*, 129 U.S. 329, 340 (1889) ("a court of equity, when properly invoked, was bound to look through and beyond the form, and have regard to the substance, and, having done so, to find and declare these preferential judgments void, under the statute, and set them aside."); *In re Seaway Express Corp.*, 1991 U.S. App. Lexis 17511, *6 (9th Cir. 1991); *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, 970 (2d Cir. 1977); *Hughes v. Machen*, 164 F.2d 983, 988 (4th Cir. 1947); *Citizens' Nat'l Bank of Gastonia v. Lineberger*, 45 F.2d 522, 527-28 (4th Cir. 1930). Similarly, courts have ignored form in favor of substance in the application of the Code's rules governing the treatment of executory contracts, including resolving the proper characterization of obligations as leases or forms of secured financing. *See In re PCH Assocs.*, 949 F.2d 585, 597 (2d Cir. 1991); *International Trade Admin. v. Rensselear Polytechnic Inst.*, 936 F.2d 744, 748 (2d Cir. 1991); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1183 (9th Cir. 1988). Likewise, courts have refused to elevate form over substance in the application of the Code's setoff rules, as well as in the recharacterization of loans as equity contributions. *See Drexel v. Berney*, 122 U.S. 241, 254 (1887) ("Equity will look through the form of the transaction, and adjust the equities of the parties with a view to its substance, rather than its form"); *In re Transystems, Inc.*, 569 F.2d 1364, 1370

(5th Cir. 1978). In addition, courts have disregarded form in favor of substance in the administration of the Code's rules dealing with the treatment of claims. *See Pepper v. Litton*, 308 U.S. 295, 305-10 (1939) (reviewing equitable powers of the bankruptcy court to adjust claims); *In re Holm*, 931 F.2d 620, 623 (9th Cir. 1991); *In re Inland Gas Corp.*, 187 F.2d 813, 817 (6th Cir. 1951); *In re Thrifty Oil Co.*, 249 B.R. 537, 544 (S.D. Cal. 2000); *In re Smith*, 249 B.R. 328, 337-38 (Bankr. S.D. Ga. 2000).

Under ordinary principles of bankruptcy law, there is no basis for the conclusion that a settled obligation is or should be immune from searching examination by the bankruptcy court in order to fulfill the Code's discharge policy. Because the decision of the court below conflicts with the basic operation of the Bankruptcy Code, it is untenable.

CONCLUSION

For the foregoing reasons, the Court should reverse the judgment of the Fourth Circuit in this case.

Respectfully submitted,

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